

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 01-0102
State Gross Retail and Use Taxes: Production Exemptions
For Tax Years 1997-1999

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ISSUE

I. State Gross Retail and Use Taxes—Exempt Items

<u>Authority:</u>	IC § 6-2.5-2-1	45 IAC 2.2-2-1
	IC § 6-2.5-3-2	45 IAC 2.2-2-2
	IC § 6-2.5-3-4	45 IAC 2.2-3-4
	IC § 6-2.5-3-6	45 IAC 2.2-5-8
	IC § 6-2.5-3-7	45 IAC 2.2-5-11
	IC § 6-2.5-5-3(b)	45 IAC 2.2-5-14
	IC § 6-2.5-5-4	45 IAC 2.2-5-15
	IC § 6-2.5-5-5.1	45 IAC 2.2-5-16
	IC § 6-2.5.5-6	
	IC § 6-2.5-5-8	
	IC § 6-8.1-1(b)	

Taxpayer protests the refund amount the Department has calculated, arguing that it is entitled to further exemptions based on its production processes.

STATEMENT OF FACTS

Taxpayer, a wholly owned subsidiary of X Corporation, is a manufacturer and distributor of various copper, brass, aluminum, nickel, and stainless steel fittings and valves for the plumbing, air conditioning, and other industrial markets. Taxpayer's protest originally began as a refund claim investigation where taxpayer requested a refund of overpayment of sales tax paid to vendors and use tax paid to the Department. Taxpayer currently argues that it is entitled to more production exemptions on purchases of materials used in its business. Further facts will be added as necessary

I. State Gross Retail and Use Taxes—Exempt Items

Taxpayer protests the refund amount the Department has calculated, arguing that it is entitled to further exemptions based on its production processes.

Under IC § 6-8.1-5-1(b), a “notice of proposed assessment is *prima facie* evidence that the department’s claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.” In the course of auditing taxpayer for the tax years at issue, it became apparent that taxpayer had overpaid the Department, and the appropriate notice was sent. The only disagreement on the proposed refund concerns the amount, which turns on taxpayer’s arguments concerning exemptions.

First, IC § 6-2.5-2-1 imposes an “excise tax, known as the state gross retail tax . . . on retail transactions made in Indiana.” Second, IC § 6-2.5-3-2 also imposes an excise tax, “known as the use tax,” “on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction.” Further, IC § 6-2.5-3-4 sets forth an exemption from the use tax:

- (a) The storage, use, and consumption of tangible personal property in Indiana is exempt from the use tax if:
 - (1) the property was acquired in a retail transaction in Indiana and the state gross retail tax has been paid on the acquisition of that property; or
 - (2) the property was acquired in a transaction that is wholly or partially exempt from the state gross retail tax under any part of IC 6-2.5-5, except IC 6-2.5-5-24(b), and the property is being used, stored, or consumed for the purpose for which it was exempted.

Under IC § 6-2.5-3-6, the individual—in this case, taxpayer—“who uses, stores, or consumes the tangible personal property acquired in a retail transaction is personally liable for the use tax.” IC § 6-2.5-3-7 establishes the presumption of taxability:

- (a) A person who acquires tangible personal property from a retail merchant for delivery in Indiana is presumed to have acquired the property for storage, use, or consumption in Indiana, unless the person or the retail merchant can produce evidence to rebut that presumption.
- (b) A retail merchant is not required to produce evidence of nontaxability under subsection (a) if the retail merchant receives from the person who acquired the property an exemption certificate which certifies, in the form prescribed by the department, that the acquisition is exempt from the use tax.

See also, 45 IAC 2.2-2-1, 45 IAC 2.2-2-2, and 45 IAC 2.2-3-4, regulations defining terms in the statute imposing the state gross retail tax, and setting forth the retail merchant’s duty to collect the tax.

There are numerous exemptions from the state's gross retail tax. IC § 6-2.5-5-3(b) provides in pertinent part:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

IC § 6-2.5-5-4 states that transactions involving tangible personal property “are exempt from the state gross retail tax if the person acquiring the property acquires it for his direct use in the direct production of the machinery, tools, or equipment described in section 2 or 3 of this chapter.” IC § 6-2.5-5-5.1 exempts tangible personal property from the state gross retail tax if it was acquired “for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing,” etc.

The relevant regulation, 45 IAC 2.2-5-8, provides generally that “all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable.” (45 IAC 2.2-5-8(a)). This is the general rule: purchases are taxable. Subsection (b) states that the state's gross retail tax does not apply to “sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.” Subsection (c) defines “direct use” as having “an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.” Subsection (d) draws the critical distinction between pre-production and post-production:

“Direct use in the production process” begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

The additional items for which taxpayer is requesting exemptions under the above statutes and regulation are ones taxpayer claims are part of its process of producing fittings and valves for industrial markets. However, many of the items taxpayer argues fall within the statutory and regulatory exemptions do not meet the strictures of 45 IAC 2.2-5-14, cited by taxpayer in the Letter of Protest. This regulation exempts from the imposition of the state's gross retail tax “sales of any tangible personal property which is to be incorporated by the purchaser as a material or an integral part into tangible personal property produced for sale by such purchaser in the business of manufacturing . . .” Subsections (d) and (e) severely limit the application of the exemption:

(d) The purchase of tangible personal property which is to be incorporated by the purchaser as a material or an integral

part is exempt from tax. “Incorporated as a material or integral part into tangible personal property for sale by such purchaser” means:

- (1) That the material must be physically incorporated into and become a component of the finished product;
- (2) The material must constitute a material or an integral part of the finished product;
- (3) The tangible personal property must be produced for sale by the purchaser.

(e) Application of the general rule.

- (1) Incorporation into the finished product. The material must be physically incorporated into and become a component part of the finished product.
- (2) Integral or material part. The material must constitute a material or integral part of the finished product.
- (3) The finished product must be produced for sale by the purchaser.

In short, the above strictures require physical incorporation of tangible personal property as a component integral to the produced product. If the tangible personal property for which taxpayer claims exemption does not meet the statutory and regulatory strictures, the production exemption cannot apply.

A. Expense Items

1. Exempt

First, there are two items taxpayer protested based on the mistaken belief taxpayer did not receive exemptions for the purchases. One involves price lists sent to out of state customers directly from the printer. The audit determined they were exempt because they were in interstate commerce: “Purchases where the vendor shipped the materials to out of state locations are considered transactions in interstate commerce and [are] not included in the adjustment.” The other item involves taxpayer’s purchase of cast iron fittings resold to taxpayer’s customers. This purchase does not appear in the audit at all as an adjustment; therefore, taxpayer has already received the exemption pursuant to IC § 6-2.5-5-8 and 45 IAC 2.2-5-15. This statute and regulation exempt from the state gross retail tax “sales of any tangible personal property to a purchaser who purchases the same for the purpose of reselling . . . such tangible personal property in the form in which it is sold to such purchaser.”

Taxpayer also received a credit for sales tax paid on non-returnable wrapping materials used as enclosures to add to contents to be sold. Pursuant to 45 IAC 2.2-5-16, such purchases are

exempt from sales tax. Taxpayer paid the tax on purchases of boxes, plastic bags, and gummed tape. Therefore, the audit properly awarded a credit to taxpayer for the sales taxes paid.

The following items are presented in the same order as taxpayer presented them in the Letter of Protest accompanying the Request for Refund.

EXPENSE ITEMS

<u>STRATUM</u>	<u>AMOUNT</u>	<u>ITEM</u>	<u>DECISION</u>
10	\$10,455.00	Label Adhesive	No
10	\$5,444.40	Price Lists	No
10	\$15,933.48	Plates & dies	No
4	\$22.10	Repair part	No
4	\$31.19	Cast iron fittings	No
4	\$22.75	Replacement parts	No
5	\$208.00	Replacement sensors	No
5	\$119.40	Tape dispensers	No
5	\$129.60	Replacement parts	No
6	\$389.50	Parts for manufacturing equipment	Yes
6	\$452.96	Parts for manufacturing equipment	Yes
6	\$252.45	Bar code labels	No
6	\$252.45	Bar code labels	No
6	\$252.45	Bar code labels	No
6	\$261.60	Label sheets	No
7	\$502.35	Repair parts	No
7	\$710.40	Blue label imprint foil	No
7	\$575.00	Wax slabs	Yes
8	\$798.00	Repair parts	No
8	\$990.00	Bar code labels	No
8	\$824.36	Copper	No
8	\$1215.78	Stapler	No
9	\$2920.00	Software	Yes
9	\$4243.54	Copper	No
9	\$2025.00	Shelving Units	Yes
9	\$4100.00	Label adhesive	No
9	\$4100.00	Label adhesive	No
9	\$2720.00	Repair parts	No
9	\$2140.00	Glue applicator unit	No
9	\$2385.00	Label applicator unit	No
9	\$2164.00	Cleats to repair conveyor for cleaning line	Yes
9	\$2106.67	Jib crane to assemble new production machine	No

9	\$2001.69	Copper	No
9	\$2027.27	Copper	No
9	\$3292.88	Copper	No
9	\$3316.16	Copper	No

CAPITAL ASSETS

<u>YEAR</u>	<u>AMOUNT</u>	<u>ITEM</u>	<u>DECISION</u>
1998	\$24,600.00	Lab equipment for quality control	Yes
1998	\$24,475.07	Cryogenic unit used for tool production	Yes
1998	\$5,730.00	Quality control equipment	Yes
1998	\$29,950.00	Quality control equipment	Yes
1998	\$14,258.34	Conveyor	No
1998	\$7,129.17	Conveyor	No
1998	\$49,904.19	Conveyor	No
1998	\$2695.39	Computer equipment to control production equipment	Yes
1998	\$6128.00	Printer for product labels	No
1998	\$12,820.00	Quality control equipment	Yes
1999	\$895.00	Quality control equipment	Yes
1999	\$1900.00	Quality control equipment	Yes
1999	\$25,237.00	Decoiler	No
1999	\$27,980.00	Quality control equipment	Yes

ANALYSIS

Three items under protest involve a dispute over the exemption percentages applied to certain purchases by the Research and Development Department (R&D). Two purchases were for parts for the manufacturing equipment R&D produces. R&D also purchased a jib crane to aid in assembling a production machine that makes “T” fittings. The crane moved work-in-process materials and is used to assemble new production equipment. Taxpayer provided no facts to support its contention that the auditor’s methodology—i.e., using a 70% exemption percentage across the board—was erroneous.

Another area of dispute concerns six purchases of #1 copper from various metal companies. The audit found that these purchases were non-exempt. The copper is first tested in R&D, and then shipped to taxpayer’s Arkansas plant for melting and shaping into copper tubing. Then it is either resold to unrelated customers or sent back to taxpayer for use in manufacturing taxpayer’s products. The entire set of purchases comprises a purchase for testing purposes, rather than for resale. It is immaterial that the copper is sold in its unformed state to other customers or copper manufactured into taxpayer’s products. The primary purpose for these purchases was for testing.

There are four remaining expense items the audit determined were non-exempt. The first item involves wax slabs R&D purchased. The audit stated the purchase was non-exempt because R&D used them for lab test materials. In this instance, however, R&D incorporated the slabs into production equipment the department manufactured. Therefore, this purchase is exempt pursuant to 45 IAC 2.2-5-8(a) through (c).

The second item involves software maintenance charges which included non-guaranteed updates. The upgrade was shipped. The audit determined these charges were non-exempt. However, according to Sales Tax Information Bulletin #2 (August 1991), optional warranties and maintenance agreements are not subject to sales and use tax because their purchase “is the purchase of an intangible right to have property supplied and there is no certainty that property will be supplied.” Therefore, these charges are exempt.

The third item involves shelving units which transport oxygen fittings from the final cleaning stage to required inspection by Quality Control. The oxygen fittings go from Quality Control to packaging. The audit determined these shelving units were non-exempt because they were transporting finished goods. Because of the nature of the goods—oxygen fittings—strict quality control standards apply. Therefore, the oxygen fittings are being transported as works in progress. The shelving units are therefore exempt pursuant to 45 IAC 2.2-5-8(f)(3), 45 IAC 2.2-5-8(d) and 45 IAC 2.2-5-8(i): “Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt.” The oxygen fittings are not finished goods until they have been tested and inspected.

2. Non-exempt

The non-exempt items concern all purchases related to packaging and certain repair parts. All purchases related to packaging are items purchased for post-production activities. These include purchases of label adhesive, plates and dies for labels, tape dispensers, label sheets attached to packages containing the fittings, blue label print foil ribbon, staplers, boxing glue, and a labeler which applies labels to boxes. These items are all used in post-production activities and therefore do not qualify for the production exemption. These items fail the “immediate effect” test of 45 IAC 2.2-5-8(g): “. . . the property must also be an integral part of the integrated process which produces tangible personal property.”

The audit also disallowed an exemption for repair parts to repair the conveyor for the cleaning line. The audit determined the conveyor was actually transporting finished goods. Cleaning the fittings is part of the production process; the conveyor transports the fittings from the wash tank to the hopper which then loads the finished goods into cardboard boxes. Therefore, this purchase is non-exempt pursuant to 45 IAC 2.2-5-8(h)(2). Since the conveyor is not exempt production machinery, the repair parts are not exempt repair parts: “Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax.” 45 IAC 2.2-3-8(h)(2).

Finally, the audit determined that taxpayer’s purchase of bar code labels was non-exempt. The labels are affixed to small, individual fittings as desired by taxpayer’s customers. IC § 6-2.5-5-6 provides that “[t]ransactions involving tangible personal property are exempt from the state gross

retail tax if the person acquiring the property acquires it for incorporation as a material part of other tangible personal property which the purchaser manufactures . . . for sale in his business.” 45 IAC 2.2-5-14(e)(1), quoted on page 4, *supra*, provides that in order for the exemption to take effect, “[t]he material must be physically incorporated into and become a component part of the finished product.” Bar code labels are not component parts of metal fittings as they are discarded upon installation, and have no affect whatsoever on the finished fitting.

B. Capital Assets

Taxpayer made a number of capital purchases which the audit determined were either entirely taxable or only 80% taxable. Items the audit determined were 80% taxable are all 100% used for quality control during production of taxpayer’s fittings. Such machinery includes those used for tensile testing of the fittings and grain analysis of the copper. R&D uses the equipment whenever product deficiencies arise. Once R&D determines the problem, production equipment and raw materials are adjusted accordingly in order to produce useable copper fittings. Taxpayer made eight such purchases. All eight are 100% exempt as the machines are directly used to have an effect on raw materials used in taxpayer’s production process. 45 IAC 2.2-5-14 (d) and (e). One of the pieces of equipment taxpayer purchased which the audit determined was 100% taxable was a cryogenic processing unit used to produce new tooling used to pressurize bars of raw materials to make the fittings. This unit is exempt pursuant to 45 IAC 2.2-5-11. The computer and software items control the production process and are also exempt.

The remainder of the capital purchases are non-exempt because they are used in pre-production or post-production work: the conveyor between the wash tank and hopper which loads completed fittings into cardboard boxes (post-production); a printer used to print labels in the boxing department (post-production); and a “header machine” that straightens coiled copper tubing prior to cutting, the first actual step in production (pre-production). Taxpayer argued that the copper tubing produced in its Arkansas plant is all part of an integrated production process that ends up at the Indiana plant to be turned into fittings. This is pre-production activity.

FINDING

Taxpayer’s protest is partially sustained and partially denied.